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Recent Trends in Combined Reporting and Apportionment

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Agenda

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- Combined Reporting
  - Recent Legislation
  - “Tax Haven” Legislation
- Apportionment
  - Classification
  - Sourcing
  - Equitable Apportionment
  - MTC Election Litigation

Unitary Combination

As of June 2015

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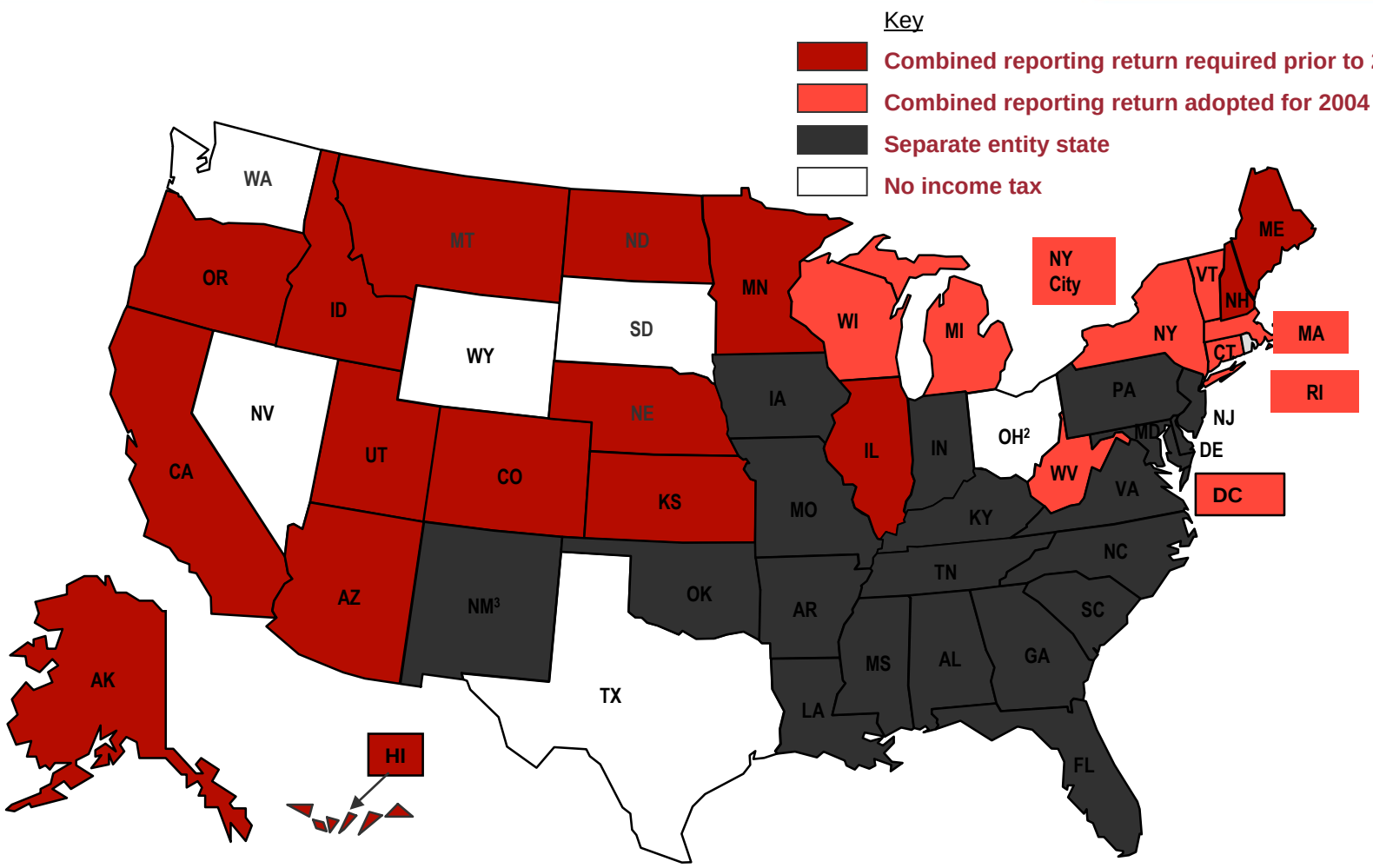

Connecticut Combined Reporting Legislation

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- On June 30, 2015 Connecticut Governor Dan Malloy signed two bills enacting budget legislation which includes mandatory unitary combined reporting for tax years beginning on or after January 1, 2016
- Combined report required if corporations:
  - Are engaged in a unitary business; and
  - More-than-50% common ownership test is met (measured by voting power)
- Worldwide filing election
- Affiliated group election
- *Finnigan* apportionment approach
- Tax haven provisions

New York Corporate Tax Reform – Combined Reporting

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- Combined report required if corporations:
  - Are engaged in a unitary business; and
  - More-than-50% common ownership test is met (measured by voting power of capital stock)
- Presence or lack of substantial intercorporate transactions or distortion is irrelevant
- Affiliated Group Election
  - Corporations that meet the more-than-50% common ownership test may elect to be treated as a combined group, regardless of whether those corporations are conducting a unitary business

Rhode Island Corporate Tax Reform

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- Changes effective for tax years beginning on or after January 1, 2015
  - Mandatory combined reporting for unitary businesses
    - 50% common ownership
    - 80/20 companies excluded
  - Tax haven provisions
  - *Finnigan* apportionment approach
  - Elective combined reporting for affiliated groups

“Tax Haven” State Enactment Status, with 2015 Proposals

As of July 2015

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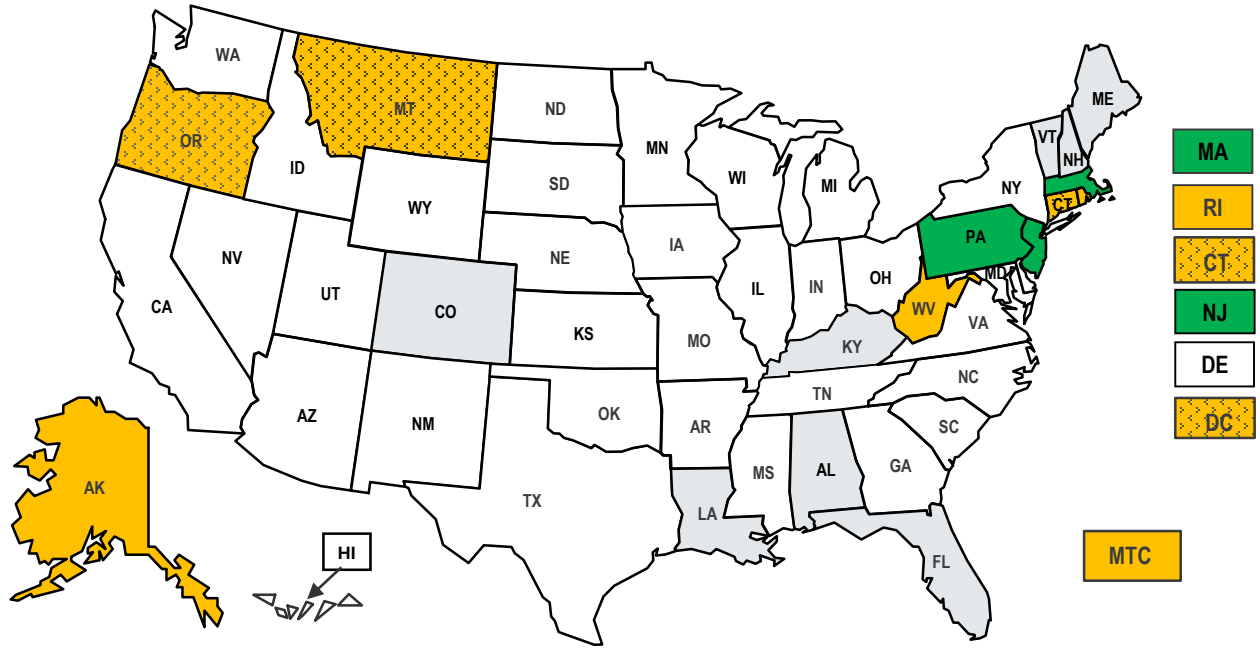
- Enacted Tax Haven Provisions
- Tax Haven “Blacklist” Included or Required in Enacted Legislation
- 2015 Proposals- Still Live
- 2015 Proposals- Not Enacted



“Blacklist” Approach

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- Montana and Oregon are currently the only two states to employ a statutory “blacklist” approach that identifies specific countries as “tax havens” (DC and CT legislation adopting a blacklist is approved, not yet effective)
- States look to whether the foreign corporation is incorporated in (or, in some cases, “doing business” in) a listed jurisdiction
- Lists typically include around 40-plus countries

MTC Approach ("Indicia")

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- Some states, including RI, WV, and DC, have leveraged the "tax haven" definition provided in the MTC's model combined reporting statute, which designates the following traits:
  - No or nominal effective tax on the relevant income, and
    - Has laws or practices that prevent effective exchange of information for tax purposes with other governments;
    - Lacks transparency;
    - Facilitates the establishment of foreign-owned entities without the need for a substantive local presence;
    - Excludes resident taxpayers from the tax regime's benefits or prohibits businesses that benefit from operating in the local market; or
    - Has created a tax regime which is favorable for tax avoidance, including whether the jurisdiction has a significant untaxed offshore financial or other services sector relative to its overall economy

Arguments by Proponents of Tax Haven Legislation

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- Assert $20+ billion state tax revenue loss
  - Perception of tax avoidance by US multinationals
  - Belief multinationals hide profits in “island economies” and low tax jurisdictions
- Income should be aligned with value creation and substance
- (Big) Business does not pay its “fair share”
- Small business disadvantaged, unable to use tax haven “loopholes”
- Failure to act at the federal level justifies state “self-help”

Arguments by Opponents of Tax Haven Legislation: The Numbers Game

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- U.S. PIRG and Citizens for Tax Justice (CTJ) have provided widely publicized estimates for state revenue losses from offshore "tax havens." For 2011, estimates for state corporate income tax revenue losses totaled about **$20 billion**
- However, in 2014, based on information from states with tax haven statutes, PIRG issued a new estimate of $1.68 billion (or $1.015 billion for states with existing combined reporting requirements)
- **Despite the new estimates, PIRG has not fully disavowed the earlier estimates**
- Source: U.S. PIRG, "Closing the Billion Dollar Loophole," Winter 2014

Receipts Classification

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- Critical preliminary step in an apportionment analysis
  - Sourcing rule
  - Throwback
- Presence or absence of direct authority
  - E.g., digital products
- Use of analogy or other authorities
  - Within the state income tax
  - Outside the state income tax
- Consistency?

Costs of Performance Sourcing

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- Several states continue to employ a costs of performance souring methodology for receipts derived from services and intangibles
  - Greater
  - Proportional
- Successful costs of performance sourcing
  - Cost accounting
  - Identifying and documenting the relevant income producing activity or activities
- Beware of interpretations of costs of performance that mirror market-based sourcing (e.g., Florida and Indiana)

Latest States to Employ Market-Based Sourcing

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- Massachusetts
- New York
- Pennsylvania
- Rhode Island
- Tennessee (*eff. July 2, 2016*)

Latest States to Employ Market-Based Sourcing

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- Massachusetts
  - Effective for tax years beginning on or after January 1, 2014
  - Receipts sourced to MA to the extent the service is *delivered* to a location in MA
  - If delivery location cannot be determined, a reasonable approximation may be employed
    - What is a reasonable approximation?
      - May base on delivery location of similarly situated sales
    - Beware – once a method is chosen, a taxpayer will be required to notify MA if a change in method is desired

Latest States to Employ Market-Based Sourcing

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- Massachusetts
  - Lengthy regulations on its market-based sourcing law that are complex and cumbersome
    - There are different rules for:
      - in-person services;
      - professional services; and
      - services delivered to, through, or for the customer
    - Sourcing is also dependent on the type of customer (e.g., individual or corporation) and the method of delivery (e.g., in tangible or electronic form)

Latest States to Employ Market-Based Sourcing

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- New York – effective for tax years on or after January 1, 2015
  - New law expands the market-based sourcing regime to all receipts ‘‘that are included in the computation of the taxpayer’s business income for the taxable year’’
  - Most service receipts ‘‘shall be included in the numerator of the apportionment fraction if the location of the customer is within the state”
  - For service receipts, determining whether the customer is in the state is done through a hierarchy of sourcing methods:
    - (1) The benefit is received in the state;
    - (2) Delivery destination;
    - (3) The apportionment fraction for the receipts within the state determined for the last tax year; and
    - (4) the fraction used for *other* “other services and other business receipts” under (1) and (2)
  - The new law requires taxpayers to exercise due diligence at each level of the hierarchy before proceeding to the next method (based on information that would be known to the taxpayer conducting a reasonable inquiry)

Latest States to Employ Market-Based Sourcing

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- Pennsylvania – tax years starting after December 31, 2013
  - Service receipts are sourced to PA if the service is delivered to a location in PA. If delivered to multiple locations, services are sourced to PA to the extent of the value of the service delivered to PA
  - If "delivery location" cannot be determined, the statute provides alternatives, depending on whether the customer is an individual or a corporation
  - What does delivery mean?
    - The PA Department released guidance stating that delivery is the location of "use." Information Notice Corporation Taxes 2014-01 (December 12, 2014)

Latest States to Employ Market-Based Sourcing

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- Rhode Island
  - Beginning January 1, 2015, receipts from transactions (other than sales of tangible personal property) are sourced to the market state — that is, the state where the recipient of the service receives *benefit* from the service
  - If the recipient of the service receives some of the benefit of the service in Rhode Island, the gross income which shall be included in the numerator of the sales factor should be proportionate to the extent the recipient receives benefit of the service in the state
- Tennessee
  - After July 1, 2016, receipts from the sale of services are sourced to Tennessee to the extent the service is *delivered* to a location in Tennessee

MTC Revisions to UDITPA

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- Services
  - If and to the extent the service is delivered to a location in a state
  - If delivery of the service cannot be determined, the sourcing location can be reasonably approximated
  - If no reasonable approximation, throw out
- Intangibles
  - Based on whether the intangible is used in the state
  - Adopts look-through for marketing intangibles
  - Distinction between receipts from licensing intangibles and receipts from the actual sale of an intangible
    - Receipts from sale only included in factor if:
      - Intangible property associated with a contractual right in a specific geographic area or
      - Contingent on subsequent use of intangible

Issues in Applying Market-Based Sourcing

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- The key problem faced by most service providers is determining where the market for their services is located. Depending on the state, the market may be:
  - (1) Where the benefit of the service is received by the customer,
  - (2) Where the service is received,
  - (3) Where the customer is located, or
  - (4) Where the service is delivered

Lack of Uniformity

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- The unique approaches to market-based sourcing often producing dramatically different results
  - PA and CA have examined the same fact pattern, with divergent results. PA guidance contains the following example:
    - A-Corp decides to outsource its payroll processing functions to Taxpayer, who manages all of A-Corp's payroll processing and reporting, including the issuance of checks to A-Corp employees. As for apportionment of receipts to PA, suppose half of A-Corp's employees are located in PA and half are located in New York. A-Corp's headquarters and human resources functions are located in PA. Taxpayer sources all of the payroll services to PA because the service is designed to meet the normal operating requirements of the company, and it is the company that uses the processing service, not the employee.
  - This result is directly contrary to California's regulation, which provides that the payroll servicing company should assign its receipts by determining the ratio of employees of the customer in California compared to all employees of the customer and assign that percentage of the receipts to California. Cal. Code Regs. 25136-2(b)(1)

Defending an Equitable Apportionment Case

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- Most states have some sort of discretionary authority to require a taxpayer to use an alternative apportionment formula
- UDITPA section 18
  - Provides for the use of alternative apportionment "[i]f the allocation and apportionment provisions of this Act do not fairly represent the extent of the taxpayer's business activity in this state…."

Defending an Equitable Apportionment Case

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- In *Vodafone Americas Holdings, Inc. v. Roberts* (Tenn. Ct. App. 2014), the court required the taxpayer to use customer-based alternative apportionment because the statutory cost-of-performance method would result in some income not being taxed in any state (so-called “nowhere income”)
- The decision is wrong
  - The issue is: what is Tennessee’s rightful share of Vodafone’s income
  - Whether some of its income is not taxed by any state is irrelevant

Defending an Equitable Apportionment Case

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- Generally, alternative apportionment is used to more accurately reflect a corporation's in-state income, but it can be used in other contexts
- In *The McGraw-Hill Companies, Inc.*, TAT(H)10-19(GC) (2014), a New York City administrative law judge held that the Department of Finance's refusal to allow a publisher to source its receipts in the same manner as other publishers violated the taxpayer's rights under the First Amendment of the U.S. Constitution

Defending an Equitable Apportionment Case

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- Discretionary authority has been used to allow for combined returns
- *Media General Commc'ns, Inc. v. Dep't of Revenue*, 694 S.E. 2d 525 (S.C. 2010) (granting a taxpayer's request for alternative apportionment on a combined basis)

Defending an Equitable Apportionment Case

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- Burden of proof:
  - The general rule is that the party seeking to depart from the statutory apportionment formula has the burden of providing that the formula does not accurately reflect the taxpayer's in-state income
  - This rule generally applies even if the revenue department is seeking alternative apportionment

Defending an Equitable Apportionment Case

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- Penalties:
  - A taxpayer that follows the statutory formula should not be subject to penalties if the revenue department successfully invokes alternative apportionment. One should not be penalized for obeying the law
  - Nevertheless, the Mississippi Supreme Court in *Equifax, Inc. v. Miss. Dep't of Revenue*, 125 So.3d 36 (Miss. 2013), *petition for cert. filed*, imposed penalties on a taxpayer that followed the statutory formula when the Department of Revenue successfully invoked alternative apportionment
  - This result has been reversed by legislation, but only if the taxpayer had a reasonable basis for relying on the statutory formula

Apportionment: MTC Election

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- Right to file using three-factor formula in MTC states
  - Article III of the Multistate Tax Compact
    - "Any taxpayer subject to an income tax…may elect to apportion and allocate his income in the manner provided by the laws of such States…or may elect to apportion and allocate in accordance with Article IV"
  - Article IV provides for a three-factor apportionment formula
    - Also provides for Cost of Performance sourcing
  - States with challenges filed: CA, MI, MN, OR and TX

Questions?

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